13.05 Equity Method, NOL & Classification

Equity Method Effects on Deferred Taxes

If an investment is accounted for under the **Equity method**, two differences need to be accounted for. There would be a Dividend Received Deduction (DRD) difference and also a deferred tax difference.

The calculation of taxes on significant investments in the common stock of other companies is unusually complex. This results from the use of the equity method of accounting for book purposes and the dividends-received deduction on dividends taxed when received.

For example, assume the client has made a 40% investment giving them significant influence over the activities of the investee, and that the following information applies to 20X1, the first year the investment is held:

Investee net income	\$500
Investee dividends paid	\$100
Dividends-received deduction	65%
Investor taxable income	\$714
Investor pretax accounting income	\$900
20X1 effective tax rate	21%
Expected tax rate in 20X2 and beyond	21%

All undistributed earnings are expected to be distributed and reported as dividend income in future years.

The difference of \$186 (\$900 – \$714) between the taxable and accounting income results from the difference in treatment of the income from the investment. For GAAP purposes, the equity method of accounting caused the investor to pick up their share of the earnings of the investee, which is \$500 × 40% = \$200 (ie, \$700 + \$200 = \$900). The dividend on the tax return is \$100 × 40% = \$40, but due to the 65% dividends-received deduction, only 35% of that \$40 dividend, or \$14, is taxed (ie, \$700 + \$14 = \$714 taxable income).

In future periods, the \$400 of undistributed earnings of the investee will be distributed, with 40%, or \$160, going to the investor. Due to the 65% dividends-received deduction, only \$56 (35%) of those dividends will be in future taxable income. The schedule to compute current and deferred taxes follows:

Year	20X1	Future
Taxable income	\$714	\$56
Accounting income	\$900	0
Difference	(\$186)	\$56
Rate	21%	21%
Current tax	\$150 (rounded)	
Deferred tax		\$12 (rounded)

Notice that the $186 difference in the current year is not the same as the future taxable amounts of $56 since most of the dividends will not be taxed in future periods.

$160 = Difference
65% → DRD → $104
35% → $56 Taxable Income → DTL → × 21% = $12

Income	Investment in S	200	
	Equity in Earnings		200
Dividends	Cash	40	
	Investment in S		40

Note: The difference of $160 will be distributed in the future, therefore resulting in future cash receipts. A taxable temporary difference (TTD) of $160 results, but is subject to a 65% DRD, so only $56 (ie, 35%) will be taxable at the future rate of 21% = $12 (rounded) Deferred Tax Liability.

Net Operating Losses

Due to the Tax Cuts and Jobs Act of 2017 (TCJA), a Net Operating Loss (NOL) is generally carried **forward indefinitely** and is limited to 80% of taxable income for the year to which it is carried. When an operating loss is carried forward, the tax effects are recognized to the extent that the tax benefit is *more likely than not* to be realized. Tax carryforwards should be recognized as deferred tax assets (DTA) in the period they occur.

DTA = Carryforward × Enacted Tax Rate

For example, in 20X1, the taxpayer has a loss of $500 and carries it forward to offset the following years' income; thus, they would have a deferred tax asset of $500 (carryforward) × 21% (ie, the enacted tax rate) for the benefit they get to use in following years. The journal entry would be:

Deferred tax asset (B/S)	105	
Income tax benefit (I/S)		105

Note: Since an NOL can be carried forward indefinitely, the 80% limitation would only need to be applied to determine a valuation allowance when an entity expects to discontinue operations and not have enough taxable income in the future to absorb the NOL.

The 2020 CARES Act **repealed** the **80% limitation** for tax years beginning **before 2021**; thus, for 2018 – 2020, NOLs may offset 100% of taxable income. It also provides that for taxable years beginning after 2020, the 80% limitation equals 80% of taxable income in *excess* of any pre-2018 NOL carryover. Therefore, any pre-2018 NOL carried forward to a tax year after 2020 is fully deductible, and any NOL created after 2017 carried forward to a tax year after 2020 is subject to the 80% limitation.

In addition, **NOLs incurred in 2018 – 2020** may be **carried back** to the **five** taxable **years** preceding the year of the loss. For example, an NOL created in 2020 may be carried back to 2015 – 2019 to receive refunds from each year in which there is taxable income. These refunds will reduce the DTA and may increase or decrease the income tax benefit depending on the tax rate for those years.

Knowing the details of the CARES Act is more important for the REG exam. Generally, in a FAR question on NOLs, they will provide the circumstances needed to calculate a DTA (whether they reflect current law or not). The CARES Act changes, however, could make it more likely that one may see a question with an NOL carried back within the exam.

Assume the same facts as in our example above, except that the taxpayer can carry back $200 of the $500 loss to tax years with a 40% tax rate. In this case, the journal entry would be:

Income tax refund receivable	80 (200 × 40%)	
Deferred tax asset	63 (300 × 21%)	
Income tax benefit		143

Classification on the Balance Sheet

All deferred tax assets and liabilities are classified as **noncurrent** amounts on the balance sheet.

The **net** amount of all deferred tax assets and liabilities, along with any related valuation allowance, is presented on the balance sheet as a **single noncurrent amount.**

Example:

Noncurrent Deferred Tax Asset	10	
Noncurrent Deferred Tax Liability		30
Noncurrent Tax Asset Valuation Allowance		5
Net balance sheet presentation: **Noncurrent** deferred tax Liability of 25		

Disclosures

Certain disclosures are required in relation to the items reported on the balance sheet. In general, they may be provided on the face of the F/S, in supplementary schedules, or in the notes to the F/S. These include:

- The components of the net deferred tax asset or liability reported on the balance sheet, including:
  - The total of all deferred tax liabilities;
  - The total of all deferred tax assets; and
  - The total DTA valuation allowance recognized, along with the net change in the allowance for the period.
- The amounts of operating loss carryforwards and tax credit carryforwards along with their expiration dates.

An entity will also provide disclosures about **temporary differences.** The specific disclosures are different for public and nonpublic entities.

- Public entities will disclose the approximate tax effect of each type of temporary difference and carryforward that affects deferred tax assets or liabilities.
- Nonpublic entities will disclose the types but are not required to disclose the approximate tax effects.

For each year presented, the significant components of income tax expense arising from continuing operations are disclosed.

- Current tax expense or benefit
- Deferred tax expense or benefit
- Investment tax credits
- Government grants
- Benefits of operating loss carryforwards
- Adjustments to deferred tax assets or liabilities resulting from changes in tax laws, tax rates, or the entity's tax status
- Adjustment to the beginning valuation allowance due to changes in judgment about the realizability of deferred tax assets

In the example above, the numbers would be netted on the Balance Sheet to show a $25 noncurrent tax Liability, as a result of netting the deferred tax Asset of $10, offset by a $5 valuation allowance, with the deferred tax Liability of $30.

A client with taxable income of $500 at an effective tax rate of 30% in 20X1 and an expected tax rate of 40% in 20X2 and beyond has the following differences between book and tax reporting as of the end of 20X1, its first year of operations:

Rent collected in advance on one-year lease agreement	150
Excess of MACRS deduction on tax return over GAAP depreciation	250
Municipal bond interest	120
Prepaid insurance on policy with 3-year remaining life	300

Current income taxes are $500 × 30% = $150.

Rent collected in advance is included in this year's taxable income but is a current liability that will only be reported in revenue on the financial statement next year. Since this will cause next year's taxable income to be lower than financial statement income, it is a future deductible amount resulting in a deferred tax asset of $150 × 40% = $60.

The depreciation difference, reflected in fixed assets in the noncurrent asset section, will cause future tax deductions to be smaller, and taxable income higher, so it is a future taxable amount resulting in a deferred tax liability of $250 × 40% = $100.

Municipal bond interest does not result in any difference in carrying values and is not a part of future financial statement or taxable income.

Prepaid insurance was deducted on the tax return when paid but will result in reductions of book income equally over the next 3 years under the matching principle with no tax deductions in those years. As a result, the $300 is a future taxable amount resulting in $300 × 40% = $120 of deferred tax liabilities.

Summarizing the tax accounts from this example:

Current income taxes on taxable income	150
Deferred tax asset on rent	60
Deferred tax liability on depreciation	100
Deferred tax liability on prepaid insurance	120

After the netting of deferred tax assets and deferred tax liabilities, the **balance sheet** will report the following:

<u>Current Liabilities</u>	
Current income taxes payable	150
<u>Noncurrent Liabilities</u>	
Deferred tax liability	160

On the **income statement,** the following will be reported in continuing operations:

- Current income tax expense 150
- Deferred income tax expense 160